Contribution Rate Stability

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Issue

- Board identified "contribution rate stability" as one of the goals under the strategic plan

Members Impacted

- All LEOFF 2 active members would be impacted
  - 14,560 members as of September 30, 2003

Current Situation

- Actuarial funding chapter
  - Chapter 41.45 RCW
- Systematic actuarial funding of the state retirement systems

History

- Pension Funding Reform Act of 1989
  - 6 year rate setting cycle
- 2 year rate setting cycle established in 1994
- Asset smoothing method set in law in 2001
- Asset smoothing method revised in 2003
- Asset smoothing corridor added in 2004

Actuarial Terms

- Actuarial cost method – "the funding method"

- Normal cost – "first mortgage payment with annual gains and losses"

- Entry age normal cost – "first mortgage payment if all assumptions are realized from entry"

- Amortization of UAAL – "second mortgage payment"

Actuarial Terms (cont'd)

- Asset valuation method – "the asset smoothing technique"
- Funding policy – "plan sponsors policy for determining the periodic contribution or cost for a plan"

Policy Analysis

- Current funding policy and methods
- Rate stability - experience
- Comparative systems
- Corridor funding
- Federal law

Current LEOFF 2 Funding Policy

- Continue to fully fund LEOFF 2
- Establish predictable employer rates which will remain a relatively constant proportion of future state budgets

Current LEOFF 2 Methods

- Actuarial cost method
  - Aggregate method
- Normal cost
  - Under aggregate method
  - 50% paid by active members
  - 30% paid by employers
  - 20% paid by the state

Current Methods (cont'd)

- Amortization of UAAL
  - UAAL = 0 under aggregate method
- Asset valuation method
  - Up to 8-year smoothing period depending on size of annual gain or loss

Analysis of Methods

- Aggregate cost method
  - Satisfies goal of fully funding LEOFF 2
  - Does not allow a UAAL to develop
  - Can produce volatile contribution rates without effective asset smoothing

Analysis of Methods (cont'd)

- Asset valuation method
  - Addresses volatility of contribution rates under the aggregate method
  - Larger the gain or loss the longer the smoothing period
- Asset smoothing corridor
  - Make sure you don't smooth too much
  - Reality check

Rate Stability - Experience

- Current policies and methods independently reasonable
- End result, however, has produced volatile contribution rates
- Why?
  - Short-term asset volatility
  - Overemphasis on short-term actuarial results
  - Interest rate change and former asset smoothing method

Comparative Systems - SCPP

- See pages 7-8 of full report
- Most establish employer contribution rates from the results of an actuarial valuation
- 4 systems have employer rates set in statute

Corridor Funding

- Two types
- Normal cost corridor
  - Rates contained within a corridor around the plan's normal cost
- Funded ratio corridor
  - Rates fixed unless plan's funded ratio falls outside corridor

Federal Law

- Section 412 of IRC
- Minimum funding rules for qualified private-sector plans
- Short-term focus
- Not a good model for rate stability
- Government plans are exempted from these rules

Options

- Minimum contribution rates
- Maximum rates of change
- Statutorily fixed contribution rates
- Corridor funding

Analysis of Options

- Set appropriate balance among several objectives
  - Rate stability
  - Rate adequacy
  - Level of cost sharing

Analysis of Options (cont'd)

- **Minimum rates**
  - Adequate, but not as stable and predictable as fixed rates
- **Fixed rates**
  - Stable, but may be inadequate in the future
- **Corridor funding**
  - Blend of minimum and fixed rate approaches
  - Funding may drop below actuarially required levels

Recommendation (cont'd)

- Establish a minimum contribution rate under the entry age method once current rates exceed entry-age rates
  - Minimum rate increased for future benefit enhancements once effective
  - Retain employee, employer and state cost sharing relationship

Recommendation (cont'd)

- Strikes the appropriate balance between rate stability and adequacy
  - Rate adequacy with aggregate method
  - Rate stability with entry age rate as a minimum